86-178

Supreme Court, U.S.
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No.

IN THE

# Supreme Court of the United States

OCTOBER TERM, 1986

JOHN FORMA,

*Petitioner*,

vs.

COMMODITY FUTURES TRADING COMMISSION,

*Respondent*.

ON PETITION FOR WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF
APPEALS FOR THE SECOND CIRCUIT

## PETITION FOR WRIT OF CERTIORARI

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## QUESTIONS PRESENTED

1. Whether non-registration with the Commodity Futures Trading Commission was a proper basis for disgorgement of petitioner's entire 1977 income.*

2. Whether disgorgement is permissible in the absence of a nexus between the amount to be disgorged and the violative conduct.

3. Whether there was evidence before the district court to support the disgorgement order.

4. Whether an order of disgorgement based on the record before the court was unconstitutional.

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* The case was originally brought in the United States District Court for the Southern District of New York by the Commodity Futures Trading Commission against British American Commodity Options Corporation and its president and sole stockholder, John Forma, the petitioner herein. The corporate defendant is in receivership and has not participated in the appeal.

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The petitioner, John Forma, respectfully prays that a writ of certiorari issue to review the opinion of the United States Court of Appeals for the Second Circuit, decided and entered in this proceeding on April 15, 1986, and the judgment entered thereon May 8, 1985.

## OPINIONS BELOW

The Memorandum Decision of United States District Judge Lee P. Gagliardi, United States District Court, Southern District of New York, filed April 18, 1985 together with judgment entered May 8, 1985 is attached hereto as Appendix A. The opinion of the United States Court of Appeals for the Second Circuit is attached hereto as Appendix B. The Order of the Court of Appeals denying a petition for rehearing is attached hereto as Appendix C.

## JURISDICTION

The per curiam opinion of the United States Court of Appeals for the Second Circuit was filed April 15, 1986 affirming judgment in the United States District Court for the Southern District of New York against petitioner filed April 18, 1985. Rehearing was denied on May 6, 1986. The jurisdiction of this court is invoked under 28 U.S.C. sec. 1254(1). The basis for jurisdiction in the district court was section 6c of the Commodity Exchange Act, as amended [7 U.S.C. Sec. 13a-1].

## STATEMENT OF THE CASE

British American Commodity Options Corporation ("BACO") commenced business as a dealer in options on futures contracts for commodities in October, 1975. On March 3, 1976 the Commodity Futures Trading Commission ("CFTC") notified BACO that pursuant to the newly enacted Commodity Futures Trading Commission Act, BACO was a commodity trading advisor ("CTA") and was required to register with the CFTC (7 U.S.C. Sec. 6m effective May, 1975. See also 7 U.S.C. Sec. 2). BACO applied for registration in mid-March, 1976 and on April 16, 1976, the CFTC instituted administrative proceedings to determine whether grounds existed for denying BACO's registration because petitioner Forma had been twice enjoined by consent from violating the record-keeping and net capital requirements of the federal securities laws and BACO had allegedly engaged in deceptive selling practices.

The CFTC had declared as a matter of policy in July, 1975 that a prior consent decree enjoining a person from any conduct or practice in the securities field constitutes good cause for denial of registration. ("Standards for Denial of Registration", 40 Federal Register 27125-26) After the administrative complaint was filed, but prior to hearing, BACO continued in business as an unregistered CTA and on July 22, 1976 the CFTC commenced an action in the district court seeking a preliminary injunction.[1] That case was assigned to the Hon. Lee P. Gagliardi, as was the case at bar.

The district court concluded following an evidentiary hearing, that merely because BACO was an unregistered CTA and was doing business in violation of the statute, it need not grant the CFTC's request for an injunction. The district court held that to deny BACO the opportunity to do business pending the outcome of the administrative hearing on the registration question was "too harsh a result," particularly so in light of the CFTC's plodding pace at the administrative level.[2] It is highly significant to note that the decision denying the CFTC's request for a preliminary injunction was dated October 20, 1976. Judge Gagliardi wrote in part:

> the mere continuation of business after the CFTC has found good cause to deny registration is not the necessary repetition of a wrong to grant the injunction. Rather, there must be some indication that a wrong connected with fraud or misconduct herein related to the alleged activity that led up to the consent decree, is to be repeated. The CFTC introduced no evidence of any illegal behavior of John Forma either leading up to the consent decree or repeated with

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[1] *CFTC v. British American Commodity Options Corp.*, (Docket No. 76, Civ. 3247).

[2] Following the denial of a preliminary injunction in October, 1976 the CFTC did hold a month long hearing to determine BACO's fitness to register as a CTA. The hearing was held before an administrative law judge from November 15 to December 15, 1976. There was to be no decision by the CFTC for almost a year.

> British American. Absent such repetition, a preliminary injunction cannot be granted under the facts of this case. *CFTC v. British American Commodity Options Corp.* 422 F. Supp. 662 (SDNY, October 20, 1976).[3]

On December 9, 1976, 17 C.F.R. Sec. 32.9 (the CFTC's general anti-fraud provision) went into effect and on January 17, 1977, 17 C.F.R. Sec. 32.3 (a) and (b) became effective. The latter rule prohibits anyone not registered with the CFTC as a futures commission merchant ("FCM") from soliciting or accepting orders for commodity option transactions.[4] On December 30, 1976 BACO applied for registration as an FCM. The CFTC on January 14, 1977 initiated an administrative proceeding to determine BACO's fitness for registration. The proceeding was consolidated with the pending CTA proceeding discussed above, but there was no final decision from the CFTC until December, 1977 (at which time BACO was no longer in business).

On April 15, 1977, while both administrative proceedings were pending, the instant law suit was commenced by the CFTC, based on purported violations of Sec. 32.3 (after January 17, 1977) and Sec. 32.9 (after December 9, 1976). The CFTC sought injunctive relief, a receiver and an order directing defendants BACO and John Forma, its sole shareholder, to disgorge all benefits derived from violative activities.

On April 22, and on May 2 and 3, 1977 evidentiary hearings were held before Judge Gagliardi on the CFTC requests for equitable relief. The court reserved decision. On August 3, 1977

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[3] We have treated this decision at length, though it was later reversed (*CFTC v. British American Commodity Options Corp.*, 560 F.2d 135 (2nd Cir. 1977) because the CFTC contended in the instant case that non-registration is a form of illegality that warrants disgorgement. The district court adopted that approach in its April 18, 1985 disgorgement order, as did the Court of Appeals in its April 15, 1986 affirmance. We contend here that such a result is especially unfair in that petitioner Forma justifiably relied on an eariler decision by the same judge holding that he may conduct his business while unregistered until there has been a full hearing and an administrative adjudication. When that decision was reversed on September 7, 1977, BACO closed its doors permanently.

[4] Both administrative regulations were promulgated pursuant to the general authority of the Commodity Exchange Act, (the "Act") 7 U.S.C. Sec. 6c(b).

the Court of Appeals for the Second Circuit reversed the prior holding of the district court dated October 20, 1976 and directed that a preliminary injunction issue. On September 7, 1977 the district court enjoined BACO from operating as an unregistered CTA and BACO ceased to be in business. It is stressed that between October 20, 1976 and September 7, 1977 BACO had operated as an unregistered entity with the sanction of the district court.

On August 31, 1978 the district court rendered its written decision which was based on findings of "flagrant" violations of the FCM registration requirements and of the anti-fraud provisions. *CFTC v. British American Commodity Options Corp.* (1977-1980 Transfer Binder) Comm. Fut. L. Rep. CCH Par. 20662, at p. 22,696 (SDNY 1978). The court conceded that while the CFTC withheld approval of BACO's FCM registration, BACO continued in business while unregistered. As for violations of the anti-fraud provision, the district court found, *inter alia*, that "[a]lthough the testimony is not without dispute," misrepresentations or incomplete explanations regarding the market mechanics of option trading were made to "virtually all of the customers who gave testimony."

On the question of ancillary relief, Judge Gagliardi concluded that the case

> amply justifies the imposition of a receivership to prevent the waste of any proceeds obtained by defendants in the course of their unregistered and deceptive options practice. *The receiver will be in a position to aid in the computation of damages incurred by defendants' conduct and to assist in any reparations proceedings. Specific orders to disgorge profits may be made upon particularized application to this court* [emphasis supplied].

On December 21, 1978 Judge Gagliardi appointed a receiver who was authorized to take steps necessary to "protect the interests of ... customers who purchased commodity options ..." from BACO. He was also authorized to mail to all customers of BACO a claim form on which they were given the opportunity to assert

claims. On July 29, 1980 the receiver was also authorized to "seek restitution for customers ..."

Although the receiver was authorized to apply for disgorgement of any unlawful benefits realized by defendants, no such application was ever made. The claim form asked basic questions of anyone who might have purchased an option on a futures contract through BACO. It asked nothing about the discussions that preceded the transaction, prior trading experience of a customer or anything else that might tend to establish a causal link between a given claim and any violative selling tactics of BACO. The only class of "claimants" ever identified by the receiver consisted of people who purchased options and lost money, regardless of the circumstances.

On August 6, 1982 the receiver submitted a proposed final report identifying approximately $1.4 million in "verified claims by 199 BACO customers." The receivership estate consisted of nearly $400,000. The receiver recommended a distribution to the 199 claimants and a windup of the receivership. He recommended no disgorgement with respect to John Forma individually, although the receivership estate consisted of BACO's former assets which would otherwise belong to Forma. There is no way to determine from the receiver's report whether claimants' losses from option transactions were the result of any wrongdoing by BACO.

On October 22, 1982 the CFTC filed a formal objection to the receiver's proposed final report because it failed to make provisions for disgorgement by petitioner Forma. The CFTC sought disgorgement of every dollar Forma received from BACO after December 9, 1976 (the effective date of Sec. 32.9). When Forma contended that his net worth is not sufficient to support further disgorgement, the receiver expressed concern about the cost of attempting to collect. The court directed further examination of Forma, primarily to determine the collectibility of a disgorgement order.

The CFTC report was filed on May 26, 1983 and, like the receiver's report before it, made no attempt to link any funds received by Forma to ill-begotten profits derived by BACO; nor

did it bother to ascertain BACO's profits from violative sales efforts. Moreover, there was nothing in the record to connect Forma's 1983 assets with proceeds realized from BACO at any time. Although BACO had perhaps 2,000 customers and wrote an estimated $50,000,000 in option business, the CFTC contended that since the court had found pervasive fraud, it was a proper assumption that all funds received by Forma after December 9, 1976 were the fruits of illegality. Forma argued that the record contained nothing after May 3, 1977 (when the evidentiary hearing ended) and furnished no basis for disgorgement of his *entire* 1977 income.

The CFTC report asked the court to order petitioner to disgorge $1,211,840 to enable the receiver to "satisfy approximately all of the verified claims of former customers." Aside from the impropriety of treating disgorgement as a function of restitution, the CFTC position presumed that all "verified claims" reflect losses attributable to wrongdoing when all they actually reflect are trading losses. Moreover, even if it had been properly ascertained that $1.4 million of claims generated by the receiver's solicitation had been lost by customers because of BACO's wrongdoing, there can be no basis for a presumption that all of the money received by petitioner Forma represents "profits" from that wrongdoing. The known facts are otherwise.

The options sold to BACO's customers were written in the first instance by grantor members of principal London Commodity Exchanges. The cost of an option included the dealer's premium charged by the London grantor and a commission or markup tacked on by BACO over and above the grantor's premium. That commission was the only element of the option price that was retained by BACO, which then paid salesmen's commissions and otherwise met its operating overhead. There is nothing in the record to indicate what BACO's true profits or benefits were during the relevant period. There is also no competent basis for assuming that Forma's entire income for any particular period consisted entirely of the fruits of illegality. The only known customer claims aggregate less than 3% of BACO's gross business. Moreover, Forma could well have drawn accumulated capital or profits from entirely proper transactions. The actual profits from the "verified claims" would in no way account for Forma's 1976-78 drawings.

On June 29, 1983 the CFTC sought a specific order of disgorgement against petitioner Forma. The disgorgement motion lingered for nearly two years. The district court on April 18, 1985 filed a memorandum decision, directing petitioner to disgorge to the receiver the sum of $1,023,375—*his entire 1977 income from BACO.* The court determined, we think wrongly, that the CFTC bore no burden to isolate the portion of Forma's income attributable to illegal activities, notwithstanding clear precedent to the contrary. The court reasoned that all of Forma's compensation from BACO "can be attributed to illegal conduct, including pervasive fraud and unregistered trading". Aside from all else, the decision ignored the fact that on October 20, 1976 Judge Gagliardi had ruled that BACO need not close its doors while the CFTC administrative proceedings were pending, which they were until December, 1977. The disgorgement order was entered nearly eight years to the day after the lawsuit was commenced.

## REASONS FOR GRANTING THE WRIT

### I. BACO'S NON-REGISTERED STATUS WAS NOT A PROPER BASIS FOR DISGORGEMENT OF PETITIONER FORMA'S ENTIRE 1977 INCOME

Appellant contends that BACO's non-registered status will not support disgorgement in the context of this case for two reasons:

#### A. *Baco's Unregistered Activities Were Lawful*

Both the district court and the Second Circuit recognized the proposition that where disgorgement is sought with respect to income from a combination of lawful and unlawful activity, the proponent must isolate the profits attributable to the latter. *SEC v. Texas Gulf Sulphur Co.*, 446 F.2d 1301 (2d Cir. cert. den. 404 U.S. 1005 (1971), at 1308; *SEC v. Blatt*, 583 F.2d 1335, 1336 (5th Cir. 1978); *SEC v. Wills*, 472 F.Supp. 1250 (D.D.C. 1978); *CFTC v. Hunt*, 591 F.2d 1211 (7th Cir.) cert. den. 442 U.S. 921 (1979).[5]

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[5] The injunctive provision of Sec. 13a-1 of the Act is in all material respects similar to Sec. 21(e) of the Securities Exchange Act of 1934, 15 U.S.C. Sec. 78u(e), and Sec. 20(b) of the Securities Act of 1933, 15 U.S.C. Sec. 77t(b), and case law developed under those sections of the securities laws is pertinent to cases under

*(footnote continued)*

However, the decisions below have erroneously relieved the CFTC of that burden on the theory that all of petitioner's income was derived from unlawful activity, be it fraudulent or non-registered. Therefore, the courts below perceived no need to make the precise calculation of fraudulently derived profits.

The district court disgorgement order thus relies very heavily on BACO's unregistered status as does the holding of the Court of Appeals. This rationale ignores the fact that BACO was *lawfully* operating without registration from October 20, 1976 to September 7, 1977. On October 20, 1976 District Judge Gagliardi had held, *inter alia*, that denial of registration by the CFTC can only come after the final outcome of its hearings to determine BACO's fitness, *British American*, 422 F.Supp, supra and BACO could continue in business while its registration application was pending. That decision remained in force until September 7, 1977 when it was overturned by the Second Circuit, *CFTC v. British American Commodity Options Corp.*, 560 F.2d 135 (2d Cir. 1977).

There can be no doubt that the district court intended to permit BACO to remain in business. Judge Gagliardi noted that BACO had built a business in one year with one hundred employees, one million dollars in net worth and nearly two thousand customers and expressed concern about the "harshful impact [of any injunction] on the personal reputation ... and legitimate business activities" of BACO. The court expressed concern that BACO's employees would be forced out of work and that its "customers would also be hurt." *British American*, 422 F.Supp., *supra*, at 668. The court reasoned that if the administrative law judge declares BACO fit to be registered "after a full hearing on the merits," a preliminary injunction would have irreparably harmed the business.

The district court was interpreting the CFTC's newly enacted rules relative to registration and opportunity for hearing (7 U.S.C.

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Sec. 13a-1. See *CFTC v. J.S. Love & Assoc. Options, Ltd.*, 422 F.Supp. 652,661 (SDNY 1976); also *CFTC v. British American Commodity Options Corp.*, 560 F.2d 135 at p. 141, n. 11. Yet, significantly, there is no comparable provision in the Act to Section 27 of the Securities Exchange Act 15 U.S.C. 78aa which has been construed to grant the court general equitable powers beyond the injunction (see *Borak v. J.I. Case Company*, 317 F.2d 838, aff'd in *J.I. Case Co. v. Borak*, (U.S. Sup. Ct., June 8, 1964).

Sec. 6, et seq.). The case was undeniably one of first impression. The court analyzed the legislative history of the statute and sought to determine Congressional intent:

> Section 6 of the Act requires that "a proper showing" be made before a preliminary injunction "shall be granted." Such language affords no sufficient basis for concluding that Congress meant special weight to be given the CFTC's decision to institute suit [citations omitted].

Judge Gagliardi wrote that "[i]f Congress had intended that the courts refrain from exercising their sound discretion in equity jurisdiction, it would have had to say so in unequivocal language in the Act." In another context the court stated:

> In an act that generally provides for automatic registration or at least requires a hearing prior to denial of registration, routine pre-hearing injunctions resulting from an expansive use of "other good cause shown" would undercut the intent of the Act.[6]

Moreover, the opinion reflects that it was rendered after a full evidentiary hearing during which the court heard live testimony from eight witnesses and reviewed BACO's sales methods and literature which the CFTC considered deceptive. The outstanding SEC consent decrees against Forma, said the court, "without any indication of unfair dealing by [BACO] ..." do not compel injunctive relief. *British American Commodity Options Corp.*, 422 F. Supp. *supra*, at 666 and 667.

Once the district court rendered its decision, it had no less the force of law than would an act of Congress. To hold otherwise

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[6] The court was focusing on Section 8a(2)(B)(ii) of the Act which provides that "[the CFTC] is authorized to refuse to register any person .. if it is found, after opportunity for hearing, that the applicant is unfit to engage in the business for which the application for registration is made ... (ii) for other good cause shown." The CFTC had declared its position that an SEC consent decree furnishes a basis for pre-hearing denial of registration for "good cause." The court rejected such a construction of section 8a because the statute gave BACO no notice that by going into business and applying for registration, they would be ineligible for automatic registered status.

would be abhorrent to the most fundamental principles of Constitutional law (U.S. Const. Amend. III Sec. 2). "It is emphatically the province and duty of the judicial department to say what the law is." *Marbury v. Madison*, 1 Cranch 137. 2 L.Ed. 60 (U.S. 1803). John Forma was entitled to rely on that decision and be guided by it in the conduct of his affairs. It remained the law until the Court of Appeals held otherwise.

The court was evidently affronted by a process whereby a government agency could simply deny registration and postpone the hearing long enough to put the would-be registrant out of business by sheer passage of time. The district court determined that Congress could not have intended such a result. It was not until December 2, 1977 (when BACO was out of business) that the CFTC rendered its decision. It is inconceivable that the CFTC suffered from a backlog of cases. The newly formed agency first became operational on April 21, 1975. [Commodity Futures Trading Commission Act of 1974, Pub.L. 93-463, 88 Stat. 1389]. Had the CFTC rendered a decision in 1976, Forma would have had no 1977 income to disgorge.

The district court made absolutely clear its intention to permit BACO to remain open. At the outset of the hearings in the instant case in April, 1977, the judge remarked:

> As long as there is delay (in the administrative process relative to BACO's registration application) they are still in business.

Even after Judge Gagliardi heard the testimony which formed the basis for his August 31, 1978 findings in the instant case relative to BACO's business practices, he was not prompted to grant a preliminary injunction. On the contrary, he adhered to his consistent position that BACO could remain in business, until it was reversed by the Second Circuit. During the hearing itself, the court's rulings reflected that position.[7]

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[7] At one point, CFTC counsel cross-examined a BACO salesman and attempted to elicit an admission that he is required to be registered with the CFTC. The salesman, Norman Brown, expressed his belief that the area of registration is in question since his application was then pending with the CFTC. The court then sustained BACO's objection that it was irrelevant whether Brown had told his customers that he was not registered.

This issue, petitioner's principal argument, is mentioned only in Footnote 2 to the Second Circuit's April 15, 1986 opinion. The Court of Appeals rejects Forma's contention that BACO's unregistered operation as an FCM "was somehow immunized" by the district court's prior refusal to enjoin BACO's unregistered CTA operation. The opinion states that FCM requirements are distinct from CTA requirements.

Actually, the CFTC's rules relative to registration and opportunity for hearing [7 U.S.C. Sec. 6 et seq.] are identical for FCMs and CTAs alike. Forma was entitled to assume after January 17, 1977 [when Sec. 32.3(a) and (b) became effective] that the same reasoning applied, especially since the same judge was assigned to both cases. That assumption was reinforced during the hearings in April and May, 1977. As noted above, the court made clear that its earlier holding extended to the FCM fitness proceedings commenced on January 14, 1977.

Moreover, the district court declined to grant a preliminary injunction even after the hearing and would no doubt have allowed BACO to remain in business right up to the Commission's final adjudication on December 2, 1977, had the Court of Appeals not reversed the CTA decision in late August, 1977. Again, on January 23, 1978 when the district court announced its decision in the instant case, the judge first established that there was indeed a final adjudication by the agency itself. The court left no doubt that it had been awaiting the outcome of administrative proceedings before determining the FCM question:

> ... [T]here were concurrent with [district court proceedings], pending before the administrative law judge, a hearing in connection with British American's application for registration as an FCM which, if it had been granted, would have mooted out completely anything that I had before me, as I understood it, and for those reasons the Court did not enter a decision in connection with the hearings that it held back in April, May of 1977. [Transcript of Proceedings, January 23, 1978]

Any distinction between the CTA and FCM registration requirements affords no basis for holding now that petitioner Forma

should have shut down BACO while its FCM registration was pending, even though the same court had ruled that it could remain open during fitness proceedings on its CTA application. Such a distinction is contrary to the district court's own stated reasoning and the facts. The CFTC had consolidated the CTA and FCM fitness proceedings.[8] Furthermore, the CFTC concedes in its appellate brief that the two questions were treated as one in the administrative forum. Both matters were before a single administrative law judge, and were decided after a single hearing in one decision by the Commission itself.

Finally, the Circuit Court states that defendants were "acting at [their] own peril" while not registered. It is respectfully submitted that BACO had no reason to suspect in the first eight months of 1977 that it was at peril, since its doors remained open with court approval. To hold now that BACO's unregistered operations were unlawful and could form a proper basis for disgorgement would mean that one heeds a district court decision at his peril. All of BACO's 1977 unregistered activities occurred while the earlier decision was the prevailing law.

### B. *Disgorgement is Only Appropriate With Respect to Violations Which Sound in Fraud*

Disgorgement is one of several remedies which a court of equity has at its disposal to redress a securities law or commodities law violation. These ancillary remedies have been recognized, not because Congress wove them into the fabric of the federal securities and commodities laws, but actually because once a showing of a violation has been made, the relevant statutes do not expressly limit the court's power to fashion appropriate remedies. *SEC v. American Realty Trust*, 429 F.Supp. 1148, 1177 (E.D. Va. 1977).

Nevertheless, disgorgement is undeniably a "drastic remedy." *SEC v. Wills*, 472 F.Supp., *supra*, at 1276. Its implementation

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[8] On April 22, 1977 at the outset of evidentiary hearings in the instant case, BACO's counsel advised Judge Gagliardi that "the FCM proceeding was consolidated with the CTA proceeding ..." This fact was not disputed by CFTC counsel.

should be subject to clear guidelines. The orders of disgorgement entered in prior cases have always been based on fraudulent conduct. The case at bar signals an unwarranted departure from long-standing precedent and would open a broad spectrum of statutory offenses to this extreme form of relief.

The only proper subject of disgorgement here would be that portion of petitioner's earnings attributable to BACO's fraudulently obtained profits after December 9, 1976 (when the anti-fraud rule Sec. 32.9 went into effect) and determined with certainty. The court in *SEC v. Wills*, 472 F.Supp. *supra*, at 1275-76 gave several examples of the types of conduct – all involving illicit profit resulting from fraud – that could form the basis for an order of disgorgement:

> [T]he cases permit the disgorgement of "illicit profits" or "proceeds," *SEC v. Manor Nursing Centers, Inc.*, such as those derived from fraudulent stock offering, *id.*; those derived from a fraudulent exchange offer, *Chris-Craft Industries, Inc. v. Piper Aircraft Corp.*; and those derived from trading in securities through the use of inside information, *SEC v. Texas Gulf Sulphur Co.; SEC v. Shapiro, supra* [citations omitted here].

The Second Circuit's prior holdings have likewise limited disgorgement to profits derived from fraud, and have evinced a longstanding cautious approach which seeks to guard against punitive assessments. See, e.g., *SEC v. Manor Nursing Centers, Inc.*, 458 F.2d 1082 (2d Cir. 1972) and *SEC v. Texas Gulf Sulphur Co.*, 446 F.2d 1301 (2d Cir.) cert. den. 404 U.S. 1005 (1971).

The circuit court held in the instant case, we think wrongly, that precedent in other circuits and in securities law decisions in the Second Circuit, supports disgorgement for both fraud and "regulatory" violations. The court cited such securities cases as *Manor Nursing* and *Texas Gulf*. Indeed, during argument, Judge Mansfield suggested that these cases involved disgorgement for registration violations, whereupon we attempted to analyze the leading Second Circuit securities decisions involving disgorgement and pointed out that they were *all* based on fraud.

These cases involved insider trading[9], fraudulent stock offerings[10] and dissemination of false prospectuses or other public documents[11]. The insider trading cases, present the simplest calculation of illegal benefits. The other cases cited, almost uniformly involve clear-cut fraud where the sum to be disgorged flows naturally from and is co-extensive with the illegal conduct.

In *CFTC v. U.S. Metals Depository*, 468 F.Supp. 1149 (SDNY 1979), Judge Weinfeld first considered the violations of the FCM registration provisions and ruled that the "finding [of non-registration] alone would suffice to grant injunctive relief. . . " *Id* at 1157. Only after consideration of defendant's fraudulent activities did the court order disgorgement. *Ibid*, at 1163.

In *SEC v. Penn Central Co.*, 450 F. Supp. 908 (E.D.Pa. 1978) the court stated:

> Should we determine that any defendant violated Sec. 17(a) or Sec. 10(b) (the anti-fraud provisions of the Federal securities laws) we have the discretion to fashion equitable relief to deprive defendants of all gains flowing from the wrong ... that remedy can include disgorgement ...

In the August 31, 1978 opinion in which the district court first considered disgorgement, it referred only to the CFTC's request for "imposition of a receiver and disgorgement of *fraudulently obtained proceeds*" [emphasis added] *British American*, CCH par. 20,662, supra, 22,706. At a hearing held March 7, 1984, the court indicated that it did not believe disgorgement was an appropriate response to a registration violation in this case.

The Second Circuit also referred to two commodities decisions in other circuits which upheld disgorgement based on illegal

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[9] *Sec. v. Texas Gulf, supra; SEC v. Shapiro*, 349 F.Supp. 46 (SDNY 1972) aff'd 494 F.2d 1301 (1974); *SEC v. Golconda Mining Co.*, 327 F.Supp. 257 (SDNY 1971).

[10] *SEC v. Manor Nursing, supra; SEC v. Commonwealth Chemical Securities, Inc.*, 574 F.2d 90 (2d Cir. 1978).

[11] *SEC v. Galaxy Foods, Inc.*, 417 F.Supp. 1225 (EDNY 1976).

(though non-fraudulent) activities, *CFTC v. Co Petro Marketing Group, Inc.*, 502 F. Supp. 806 (C.D.Cal. 1980) aff'd. 680 F.2d 573 (9th Cir. 1982) and *CFTC v. Hunt*, 591 F. 2d 1211 (7th Cir.) cert. den., 442 U.S. 921 (1979).

The *Hunt* case involved violations of CFTC rules setting trading limits in certain commodities on the ground that excessive speculation can cause adverse price fluctuations. Congress [in Sec. 4a(1) of the Act] authorized the CFTC to restrict positions held or trading done by any one person or groups of people acting in concert. The district court found that the Hunt family exceeded the speculative limit of 3 million bushels established for soybean futures. At one point, the Hunt family's collective position was 45 million bushels.

The Seventh Circuit found that the violative soybean trading was carefully organized, large scale, systematic and preconceived. *Id.* at 1220. The Hunts' activities were wilful and they maintained their soybean positions throughout CFTC enforcement proceedings challenging them. The circuit court also ruled that the district court's denial of disgorgement was precipitous in the absence of a hearing on the merits of the propriety of that relief. The case was remanded after a finding that a district court may compel a violator of the trading limit provisions to disgorge his illegally obtained profits.

Under the circumstances we submit most respectfully that the Second Circuit's reliance on *Hunt* is misplaced on the issue of possible disgorgement for non-fraudulent activities. Moreover, in light of the organized, pre-conceived, systematic and mammoth nature of the Hunt family's activities, they can hardly be regarded as technical. Unlike non-registration, excessive trading is a *direct cause* of price fluctuations and directly yields profits to the perpetrators and losses to others. There would appear to be a fine line at best between such violations on the Hunt level and fraud.

*CFTC v. Co Petro Marketing Group, Inc.*, supra, is also cited by the courts below for the proposition that all illegal profits—not just those derived from fraud—should be disgorged. Co Petro's marketing scheme consisted of the sale of contracts for the future

purchase of petroleum products to private investors in violation of the prohibition in the Act against making such contracts for future delivery other than through a member of a board of trade which has been designated a contract market [7 U.S.C. Secs. 6, 6h (1976)]. The defendants sought to mask their contracts as "cash forward contracts," i.e. contracts providing for sale of a commodity for future delivery which are exempt from regulation [7 U.S.C Sec. 2]. Contrary to their claim that they were merely selling tankloads of gasoline, their customers were people who had neither the intention nor the capacity to take delivery of such quantities, and the trial court found that Co Petro solicited and made disguised future contracts, though not a "contract market."

The district court took note of two prior mail fraud convictions of the corporate president, as well as two SEC injunctions involving commodity options and a cease and desist order under the Act for converting customers' funds, to rebut the contention that the violations were technical and innocent.

There too, the violations were in no way analogous to non-FCM registration as suggested by the opinion below. The Ninth Circuit found specifically that Co Petro's conduct "was carefully planned, tightly controlled and systematically carried out." *Co Petro*, supra 680 F. 2d at 582, n. 16. Unlike BACO which did an estimated 50 million dollars in business before and after the FCM registration rule, every contract sold by Co Petro involved an intrinsically illegal product, thereby justifying disgorgement of *all* profits. Significantly, the district court there ordered a comprehensive accounting to determine precisely what the individual defendants received from activities found to be unlawful. We submit that although in *Co Petro*, the violations are not denominated as fraud, they did not involve registration, they did involve wilful misconduct that is certainly the equivalent of fraud and the case lends no support to the generalized disgorgement ordered here[12].

No prior securities or commodities law decision has based disgorgement on non-registration and it is submitted that this

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[12] A dissenting judge in *Co Petro, supra*, 680 F.2d at 584, would reverse in the absence of proof that sales by Co Petro were used for hedging or to influence price; the evils which concerned the drafters of Section 4(h).

is not the case to set such a precedent. By establishing two broad categories of violative conduct, fraud and "regulatory," the circuit court has placed BACO generally in the same group as *Hunt* and *Co Petro*. There is a material difference, however, between a technical violation that does not cause losses to investors[13] and conduct which is so egregious as to be tantamount to fraud.

## II. DISGORGEMENT IS NOT A PUNITIVE MEASURE AND IS PERMISSIBLE ONLY IF A NEXUS BETWEEN THE AMOUNT TO BE DISGORGED AND THE VIOLATIVE CONDUCT IS DEMONSTRATED

In *SEC v. Texas Sulphur Co.*, supra, 446 F.2d at 1308, the Second Circuit stated:

> Because disgorgement cannot be awarded for punitive purposes, [t]he court's power to order disgorgement extends only to the amount with interest by which the defendant profited from his own wrongdoing. Any further sum would constitute a penalty assessment.

Indeed, in *SEC v. Blatt*, 583 F.2d 1335 (5th Cir. 1978) the circuit court demonstrated its concern that the formidable equitable remedy of disgorgement be imposed with precision when it ruled that the trial court erred in requiring certain defendants to pay trustee's expenses. It held that the court's equitable power is broad enough to permit it to order defendants to pay "up to the amount of the fee realized by each defendant for his assistance in executing the fraud" [*Id.* at 1336]. Thus, before disgorgement may be ordered, a plaintiff must establish a nexus which links the defendant's fraudulent conduct to his profits.

Judge Gagliardi, citing *Blatt*, supra, in the disgorgement order of April 18, 1985 [APPENDIX A] acknowledged that the purpose of disgorgement is not to compensate victims or punish wrongdoers; rather it is a remedial measure aimed at depriving

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[13] It has been held that mere failure to register is not sufficient to justify a private action for rescission under the Act. The decisions in *Hofmayer v. Dean Witter & Co.*, 459 F.Supp. 733. (No. Dist. Calif. 1978) and *Moody v. Bache & Co.*, 570 F.2d 523 (5th Cir. 1978) suggest that a causal connection cannot be established between failure to register and customer loss.

the wrongdoer of his ill-gotten gains. However, when the court ordered petitioner to disgorge his entire 1977 income from BACO, however and whenever derived, without the benefit of any analysis or calculation which might have revealed with some exactness the company's profits from wrongdoing and Forma's benefits therefrom, it plainly constituted a penalty assessment.

In *SEC v. Wills*, 472 F.Supp. 1250 (D.D.C. 1978) the court (Judge Gesell) stated that "in this case plaintiff has failed to demonstrate any reasonably close link between defendants' 1974 and 1975 corporate compensation and their illegal conduct." Denying disgorgement, the court continued:

> When the amounts to be disgorged cannot be related with sufficient certitude to defendants' securities law violations, the SEC's disgorgement request takes on the character of a plea for punitive relief. The cases, however, are unanimous in refusing to accede to such a demand. *Id.* at 1276.

Generalized labels such as "pervasive fraud" and "illegal enterprise" do not supplant the need for the certitude described in *Wills* and *Blatt*. In *Wills*, the SEC asked the district court to order the defendants (corporate officers) to disgorge the compensation they received during the time period in which they caused certain material misstatements and omissions to be made in the corporation's public filings in violation of the anti-fraud provision [Sec. 17(a)] of the Securities Act of 1933. Judge Gesell declared that it is not for the court to decide the precise nature of the causal link which the SEC must show between defendants' violations and the profits in question.

The district court in the case at bar suggested in its April, 1985 decision that *Forma* had an ample opportunity to "present evidence" on the issue of disgorgement. In a comparable context, the district court in *Wills* found that the SEC had offered no evidence on points which might have amounted to a "causal link" and "now contends that the ***defendants*** bore the burden of first coming forward with evidence relating to this matter [emphasis supplied]. This last contention is totally devoid of merit."

There is nothing in the record here to establish any nexus between the $1,023,375 that petitioner Forma has been ordered to

disgorge and any violative conduct on his part. It would require a giant leap to bridge this evidentiary gap. One would need to assume that all of BACO's transactions were fraudulent, all of its customers lost money on all of their trades, BACO's operations during the relevant period were profitable and the money drawn by petitioner represented his share of BACO's commissions in 1977 referable to the bad trades after payment of expenses. Such a set of presumptions ignores the known facts. Here, the court-appointed receiver might have provided the court with the requisite calculations. However, the CFTC-designed questionnaire merely yielded data from customers who had lost money for any reason, without reference to the violations found by the court. Neither the court nor its receiver ever attempted to gather information required by law to calculate the proper extent of disgorgement. Customer claims of out-of-pocket loss such as resulted from the receiver's efforts, are irrelevant in determining whether, and for how much, disgorgement should be ordered. As Judge Friendly stated in *SEC v. Commonwealth Chemical Securities, Inc.*, *supra*,

> [T]he primary purpose of disgorgement is not to compensate investors. Unlike damages, it is a method of forcing a defendant to give up the amount by which he was unjustly enriched.

The court never made such a determination. The fact that it might require a great deal of investigation is no justification for seeking a shortcut. As it was, the process from the start of the suit to the disgorgement order consumed eight years. In *SEC v. Penn Central Co.*, *supra*, the trial court wrote:

> [D]etermining the scope of the equitable remedy of disgorgement entails an analysis separate from assessing whether the SEC has stated a cause of action ...

The evidence here failed to establish that each commodities transaction for which Forma ultimately received income involved a fraud on BACO customers. In *CFTC v. Hunt*, *supra*, the Seventh Circuit did find that disgorgement was a permissible remedy, but it took pains to stress that "[t]his conclusion, however, does not complete our inquiry." The court referred next to the

"complex evidentiary problems involved in the attempt to isolate the profits achieved by the Hunt family ..." The opinion went so far as to cast doubt on the court's ability to ever determine "with some precision what amounts should be disgorged" and made clear that there would have to be additional "arguments and evidence [on remand] regarding the feasibility of this form of remedy in the instant case." *Hunt, supra*, 591 F.2d at 1223.

Judge Gagliardi recognized the principle of the *Hunt* and *Wills* cases that where disgorgement is sought with respect to income from both lawful and unlawful activity, the proponent must isolate and prove the profits attributable to the latter [see APPENDIX A] but relieved the CFTC of that burden on the theory that 1977 earnings that were not derived from fraud were in any case the product of BACO's unregistered activity.

The Second Circuit likewise relieved the CFTC of its evidentiary burden on two distinct grounds. Firstly, the court held that "[t]he instant case differs, however, since appellant was involved not in isolated instances of fraud, but in systematic and pervasive fraud." As will be seen in Point III, *infra*, the district court had no evidentiary basis for presuming that BACO was corrupt from top to bottom and indeed had found to the contrary in its earlier holding. Especially in light of the limited scope of the hearings held in 1977, this case is no exception to the rule requiring concrete proof of illegally derived profits. There could be no more venal and systematic fraud than those found in the *Manor Nursing* and *Commonwealth Chemical* cases. Both led to criminal prosecutions. Yet the Second Circuit was careful in both cases to limit disgorgement to profits which truly flowed from the wrong, guarding against punitive assessments.

In addition, the Second Circuit found in the case at bar that petitioner's "failure to register as an FCM ... also was a violation of the Commission's regulations."[14] The Court would appear to be saying that the fraud and the non-registration each furnishes an independent basis for the disgorgement order. It perceived

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[14] BACO did not "fail to register." In fact, on December 30, 1976, it applied for registration as an FCM. The CFTC commenced an administrative proceeding to determine fitness on January 14, 1977.

a problem in "finding *any* activity that was lawful." Most respectfully, we maintain that this sweeping indictment is unfounded.

In the first place, it ignores what has been said above to the effect that BACO was *lawfully* operating without registration at least from October 20, 1976 to September 7, 1977. Secondly, it ignores controlling and long-standing precedent in the Second Circuit and elsewhere limiting disgorgement to profits flowing directly from fraud. Finally, we implore this Court to look beyond the labels and in particular, review the highly limited hearings held in April and May, 1977, which were woefully inadequate to support an order of disgorgement. The courts below incorrectly determined that the CFTC bore no burden to isolate the portion of petitioner's income attributable to illegal activities. We submit that the fall-back position adopted by the courts, (i.e., whatever was not traceable to fraud was the result of non-registration), was erroneous as a matter of law and cannot obviate the need to prove the requisite causation.

No prior securities or commodities case in which disgorgement was granted poses the nexus problems presented here. In *Blatt*, supra, one defendant was ordered to disgorge profits he made by fraudulent sale of stock based on inside information. In *Commonwealth Chemical*, supra, defendants were ordered to disgorge actual profits realized from their market manipulation and trading in the securities of a public company after fraudulently concealing the underwriter's failure to complete the offering. In *SEC v. Golconda Mining Co.*, 327 F.Supp. 257 (SDNY 1970) Judge Weinfeld required defendants to disgorge the profits realized as a result of insider trading. In *Manor Nursing*, supra, defendants created the false appearance that all shares required to be sold were sold in order to cause a fraudulent stock offering to close. Selling stockholders, all of whom actively participated in the fraud, were ordered to disgorge the fraudulently obtained proceeds of their stock sales. In *SEC v. Galaxy Foods, Inc.*, 417 F.Supp. 1225 (EDNY 1976) a corporate executive had fraudulently concealed certain compensation in the form of overrides on sales of franchises. The court deemed it inequitable to make him disgorge his full salary but did require disgorgement of the value of a franchise he had been given free of charge.

In *SEC v. Penn Central Co.*, supra, the trial court found the requisite causal link where defendants engaged in a scheme to misrepresent the financial condition of several corporations by exaggerating income and concealing weaknesses in financing. They did so in order to perpetuate their employment agreements which compensated them based on reported income. They thus received money which they would not have received but for their fraud.

In the case of *SEC v. Shapiro, supra*, defendants were ordered to disgorge actual profits derived by them from trading in stock while in possession of undisclosed material inside information. The landmark decision of the Second Circuit in the *Texas Gulf Sulphur* case, supra, likewise held that corporate insiders who had purchased stock prior to public disclosure of a major ore deposit could be ordered to give up the profits they had derived from insider trading. The court there upheld the general equity power of the district courts to seek ancillary remedies "to effectuate the purposes of the [Securities] Act, so long as such relief is remedial relief and not a penalty assessment." (446 F. 2d at 1308).

In all of the decisions reviewed above, the extent of disgorgement coincided with the extent of fraud. The insider trading cases, which spawned disgorgement as a logical extension of the district court's equity powers in cases brought by the SEC, present the simplest calculation of illegal benefits. The other cases cited almost uniformly involve hard core or clear-cut fraud where the sum to be disgorged flows naturally and discernibly from the illegal conduct. The instant case is more complex and requires far more detailed analysis in order to ascertain the profits derived from wrongdoing. We submit most respectfully that the courts below erred in failing to limit disgorgement to such income as could be stated with certainty to have represented profits from fraud.

## III. THERE WAS NO EVIDENCE BEFORE THE COURT TO SUPPORT THE DISGORGEMENT ORDER

The opinion of the Court of Appeals assumes incorrectly that the district court conducted "extensive hearings" in April and May of 1977. An examination of the record of those hearings reveals their limited nature and in any event, they were not disgorgement hearings.

A. *Limited Scope of Hearings*

The hearings held on April 22, May 2 and May 3, 1977 plainly did not have as their purpose a calculation of an appropriate disgorgement sum. Indeed, the subject never arose. The CFTC did not offer a single witness nor did it introduce any competent evidence relevant to the disgorgement question. The district court heard testimony from seven individuals, who either purchased options or received solicitations, and received in evidence, transcripts of testimony given in administrative hearings by eight others. Curiously, the court found "flagrant" violations of the FCM registration requirements, while conceding that BACO applied for FCM registration on December 30, 1976, *British American*, (1977-80 Transfer Binder) CCH Par. 20,662, *supra*, and even though the court itself had declared that BACO could remain open while unregistered.

With respect to anti-fraud violations, the district court found, *inter alia*, that misrepresentations or incomplete explanations regarding the market mechanics of option trading were made to "virtually all of the customers who gave testimony," *Id.* BACO also "exaggerated" the probable returns and understated the general risks.

The witnesses did not "virtually all" describe misrepresentations or incomplete explanations. A number of them were working with the CFTC at the time they spoke to BACO salespeople and it is difficult to tell whether a given witness' account was influenced by that fact. The hearings unquestionably do not show that all of BACO's transactions were fraudulent and it is evident that customers made money. John Forma testified that BACO retained as its net share of commissions, 20% of the option price on the average, less the firm's overhead.

Much of the testimony was vague and some of the CFTC's witnesses actually gave testimony that was favorable to BACO. Not a single witness testified that he or she lost a specific amount of money as a result of BACO's deceptive selling tactics. Indeed, while one investor witness was testifying, the court noted:

> [W]hether or not she made or lost money isn't relevant to our proceeding here[15].

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[15] Transcript of Hearing, April 22, 1977 (testimony of Maralyn Schneider.

More importantly from the standpoint of disgorgement, there was not a shred of evidence of what BACO earned from even one transaction that resulted from fraud. That was not the purpose of the hearings. They were conducted a few short months after the action commenced.

It was clear that the district court and the CFTC regarded the April and May, 1977 sessions as hearings on a motion for a preliminary injunction[16]. At one point CFTC counsel stated:

> This is a preliminary injunction. The only question is whether there was probable cause to believe there was fraud . However, this has come up rather speedily and we would assume that we could develop the issues a great deal more on a hearing for a permanent injunction. [Transcript of Hearing, Humm Testimony, p. 413]

The trial court itself seemed to contemplate further hearings, since it invited BACO to renew a motion for a directed verdict (made at the close of hearings) "at the end of the entire case[17]."

The Court also observed at one point:

> The only issue was whether or not there was fraud in connection with the *preliminary injunction* [emphasis added]. That is my understanding of what we were going to try here ... (See Transcript of Hearing, May 2, 1977, pp. 224, 228)

Whatever the nature of the hearings, the CFTC offered no evidence relevant to disgorgement. The testimony of a handful of witnesses including customers or would-be customers cannot support the sweeping disgorgement order entered in this case. There is no basis in the trial record for a presumption that all of BACO's $50,000,000 of option transactions were violative. Indeed, it is submitted that, if anything, petitioner is entitled to a presumption of regularity.

The hearings cannot support the disgorgement order and since much of the testimony adduced was conflicting and inconclusive

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[16] Transcript of Hearing, May 2, 1977 (testimony of Wolkis) p. 228.

[17] Transcript of Hearing, May 3, 1977 (testimony of John Forma) p. 472.

and the court itself notes that the findings relative to fraud are "not without dispute," *British American*, CCH Par. 20,662, *supra*, at p. 22,700, a finding of "pervasive fraud" was unfortunate. It has become a catchword in this case and has been used to justify imposition of an extreme form of remedial relief without the evidentiary safeguards universally mandated by the cases. It is as though the courts are saying that BACO was a bad operation and there is no point in putting the government to an onerous burden of proof. In actuality, the trial court saw fit to continue BACO in business following the April-May, 1977 hearings, after having ruled six months earlier that:

> with no evidence that it is mistreating or misleading its customers or the general public, [BACO] does no apparent harm to the public interest by being allowed to do business. *British American*, *supra*, 422 F. Supp. at 688.

B. *Forma Cannot be Subject to Disgorgement For BACO's Fraudulent Activities After May 3, 1977 — The Last Hearing Date*

The evidence before the court spanned only four months in 1977. There is no evidence in the record of fraudulently derived income for those four months and the district court certainly had no basis for calculating disgorgement *beyond* that period. The court's own findings of "misrepresentations" by salespeople extend only "through 1976 and *early* 1977," *British American*, CCH Par. 20,662, *supra*, at p. 22,700 [emphasis supplied]. The court declined to order disgorgement for the last month of 1976 because the "CFTC has not presented an adequate evidentiary basis ... " (APPENDIX A). There is no rationale for treating the 1977 income any differently.

The court was not entitled to presume that BACO's post May 3 operations were fraudulent. Nor does branding it an "illegal enterprise" compensate for such evidentiary shortcomings. The CFTC points to a single colloquy in which Forma testified in November, 1984 that BACO did not "alter its business procedures" between 1976 and September, 1977. It is a shameful distortion to suggest that this was tantamount to an admission of fraud on

the part of BACO after May 3, 1977[18]. The district court found that Forma failed to allege that he ever "conformed to CFTC regulations" between May and September, 1977 (APPENDIX A). The notion that it was Forma's burden to "allege" compliance is contrary to well-settled law as discussed earlier.

The Second Circuit opinion refers to "a series of depositions and hearings." The depositions of Forma in early 1983 and late 1984 supplied no evidence of post-May 3, 1977 fraud. On January 14 and April 13, 1983 Forma was examined as to his finances. Similarly, the focus of Forma's November, 1984 examination was the winding down of BACO *after* September, 1977 and Forma's income therefrom. Proceedings subsequent to May 3, 1977 shed no light on BACO's modus operandi.

There was not even a superficial attempt to explore BACO's method of doing business between May 3 and September 7, 1977. At that point a serious analysis would have been impossible. BACO's books and records of account had languished at the United States Attorney's office since some time in 1978 when the CFTC brought them there in an unsuccessful attempt to interest the Justice Department in a criminal investigation.

Thus, any attempts to tie petitioner Forma's compensation after the May 3, 1977 final hearing date to any violative activities are based on pure speculation. Regardless of BACO's selling practices as the district court perceived them, the company was not selling an intrinsically illegal product as was *Co Petro, supra*, and *U.S. Metals, supra*, and there can be no justification for treating all Forma's 1977 income as flowing from illicit profits.

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[18] The colloquy was as follows:

> Q. Aside from the slight variations in revenue, were there any changes in the business of British American between 1976 and the termination of its business in September of 1977?
>
> A. No.
>
> Q. Were there any changes in procedures at British American during that time period?
>
> A. No.

C. *No Evidence in Record of Fraudulently Derived Profits*

Neither the receiver nor the CFTC ever looked at BACO's books and records. The disgorgement order simply assumes that every transaction was fraudulent. That presumption is belied by the known facts. The hearings furnish no basis for assuming that BACO's enormous volume of business was tainted. The receiver's questionnaire unearthed 199 people who lost money via option trading and revealed nothing regarding the violations found by the court.

The "pervasive" label should not be used to relieve the government of its evidentiary burden. Significant BACO activities were shown to have been lawful. The district court's October 20, 1976 decision found no evidence of "mistreating or misleading" customers after extensive hearings. John Forma's testimony that as much as $15,000,000 of options were exercised is unrefuted.

BACO is entitled to a presumption of regularity in the absence of specific evidence that particular profits were fraudulently gained. Judge Meskill asked at argument whether this was not a heavy burden to place on the government; however, the cases uniformly place it there when the government seeks this extreme remedy. To do otherwise would be punitive and clearly confiscatory, as we believe this decision was (Point IV, *infra*).

It seems especially inappropriate to assume that all income received by Forma after September 6, 1977 when BACO discontinued its business was compensation for fraudulent activities. Forma has testified that he continued working for BACO after that date to wind down the business. Part of the cash on hand derived from "'75, '76, '77, all of the years" (Forma Transcript, November 11, 1984, p. 375). Significantly, the district court has credited Forma's affidavit to the effect that as of August, 1976 BACO had one million dollars in net worth. *British American*, supra, 422 F. Supp. at 668. That was prior to the alleged illegality and may very well have been the source of his 1977 earnings.

Indeed Forma has testified that 1976 was a "super year" and that "[s]ome of that cash went into 1977." Portions of the $1,023,375 received by him in 1977 undoubtedly derived from activities before December 9, 1976 when there could have been no violation of CFTC Rules 32.3 or 32.9.

Thus, because there is no evidence tying fraudulent acts during the relevant period to profits received by Forma from BACO in 1977 with any specificity, the district court had no proper basis for its April, 1985 disgorgement order. Moreover, it is submitted that when such an order is entered eight years after suit was commenced, and under circumstances where disgorgement is not feasible and the order can only result in petitioner being saddled with an onerous money judgment for the rest of his days, it must be regarded as punitive and thus improper.

The circuit court accepts the district court's conclusions that petitioner was involved not in isolated instances of fraud, but in systematic and pervasive fraud. The court's opinion notes that the problem is "finding any activity that was lawful." We say that no one ever really looked. The evidence adduced at the limited 1977 hearings furnishes no basis for relieving the CFTC of the burden to trace the actual fruits of fraud.

## POINT IV

## AN ORDER OF DISGORGEMENT BASED ON THE RECORD BEFORE THE COURT WAS UNCONSTITUTIONAL

Taking John Forma's property through a disgorgement order without a full-scale evidentiary hearing to accurately determine the proper level of disgorgement violates the Fifth Amendment guarantee that: "No person shall ... be deprived of ... property, without due process of law ..." U.S. Const. Amend. V.

In *Mathews v. Eldridge*, 424 U.S. 319, 334-35 (1976), the Supreme Court laid down the following guidelines for due process analysis:

> [O]ur prior decisions indicate that identification of the specific dictates of due process generally requires consideration of three distinct factors: First, the private interest that will be affected by the official action; second, the risk of an erroneous deprivation of such interest through the procedures used, and the probable value, if any, of additional or substitute procedural safeguards; and finally, the Government's interest, including the function involved and the fiscal and administrative burdens that the additional or substitute procedural requirements would entail.

Generally, the courts have found that the administrative burdens outweigh the interests of the property owner only where (1) the deprivation is only temporary and can be promptly contested; (2) the deprivation is necessary to protect the interests of other claimants to the property; and (3) procedural safeguards minimize the risk of erroneous deprivation. *See, e.g., Mitchell v. W.T. Grant Co.*, 416 U.S. 600 (1974) (upholding a sequestration procedure on the grounds that the debtor had a statutory right to a prompt post-sequestration hearing, and the temporary deprivation was necessary to protect the interests of other claimants to the property). Conversely, courts have struck down as unconstitutional procedures that (1) permanently deprive a person of property, (2) that is not a risk of removal, when (3) no procedures protect against erroneous deprivation. *See, e.g., North Georgia Finishing, Inc. v. Di-Chem, Inc.*, 419 U.S. 601 (1975) (garnishment); *Fuentes v. Shevin*, 407 U.S. 67 (1972) (replevin).

In *North Georgia Finishing*, supra, at 607 the Supreme Court struck down a procedure under which a plaintiff obtained a writ of garnishment by submitting a sworn affidavit. The Court held that the deprivation of the defendant's use of his funds, although temporary, was based on "mere conclusory allegations," and was therefore unconstitutional. *North Georgia Finishing* and the other due process cases stand for the proposition that a person may not constitutionally be permanently deprived of his property unless (1) sufficient evidence has been presented to justify the deprivation and (2) the person has an opportunity to contest the deprivation. The procedure followed in the instant case contravenes both of these basic due process principles.[19] Based on the CFTC's conclusory allegations, the district court ordered *permanent* deprivation of the defendant's property without receiving any evidence regarding the appropriate amount of the deprivation, and thus without giving the defendant any opportunity to refute such evidence and thereby contest the plaintiff's assertions. No minimum standard of due process is met under this irregular

[19] This argument was made below and was ignored by the district and circuit courts, except that Judge Gagliardi observed that the defendant had opportunities during the hearing and thereafter "to present evidence on this issue."

procedure. The order for disgorgement, based on this record, amounts to an unconstitutional taking without due process of law.

## CONCLUSION

The disgorgement order is without evidentiary support and is bottomed on labels, presumption and arbitrariness. It is contrary to precedent which universally requires isolation of profits from wrongdoing. Non-registration provides no basis for disgorgement, particularly in the circumstances of this case where such profits cannot be said to be unlawful. Referring to BACO as an illegal enterprise characterized by pervasive fraud does not relieve the government of its evidentiary burden. The disgorgement order violated petitioner's constitutional rights inasmuch as it worked a deprivation of property without due process of law.

For these reasons, the petition for writ of certiorari should be granted.

Respectfully submitted,

LOWY & CHERNIS, P.C.

By: /s/ Paul Chernis
(A Member of the Firm)
Counsel for Petitioner

# APPENDIX

## APPENDIX A

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

----------X

COMMODITY FUTURES TRADING COMMISSION,

Plaintiff, 77 Civ. 1822

— against —

BRITISH AMERICAN COMMODITY OPTIONS CORP. AND JOHN FORMA, MEMORANDUM DECISION

Defendants.

----------X

GAGLIARDI, D.J.

Plaintiff Commodity Futures Trading Commission ("CFTC") has moved for an order compelling defendant John Forma, the sole stockholder in defendant British American Commodities Options Corporation, to disgorge either $1,211,840 or $1,035,845. The CFTC claims that such figures represent the proceeds Forma received from conduct violative of administrative regulations.[1] Forma opposes the CFTC's application.

*Background*

In its amended complaint in this action, the CFTC alleged, *inter alia*, (1) that from January 17, 1977, British American, aided and abetted by Forma, had acted as a futures commission merchant ("FCM") in violation of registration requirements, 17 C.F.R. §§ 32.3(a) and (b), and (2) that from December 9, 1976, British American, aided and abetted by Forma, had conducted a fraudulent sales campaign in violation of 17 C.F.R. § 32.9. The CFTC sought injunctive and ancillary relief, including the appointment of a receiver and "an order directing all defendants to disgorge . . . all benefits, including, but not limited to salaries

and commissions derived directly or indirectly from the violative activities."

The court held evidentiary hearings in April and May, 1977, concerning the CFTC allegations and a further hearing on January 23, 1978, concerning defendants' claim of mootness. In an opinion filed August 31, 1978, the court found "abundant and convincing proof that the defendants had committed flagrant violations of the futures commission registration requirements and of the general anti-fraud provisions . . . and that an injunction against future violations must issue." *CFTC v. British American Commodities Options Corp.*, [1977-1980] Comm. Fut. L. Rep. (CCH) ¶ 20,662 (August 31, 1978). The court also granted the requested ancillary relief, directing that "[s]pecific orders to disgorge profit may be made upon particularized application to this court."

Thereafter Thomas Egan, Esq. was appointed the permanent receiver of British American and was authorized to apply "for disgorgement of any unlawful benefits or gains realized by the Defendants from their violative activities. . . ." However, in his report of August 6, 1982, the receiver sought disgorgement from British American but not from Forma personally. The CFTC objected to the report's failure to recommend disgorgement from Forma and, after completing discovery, made the motion now pending before the court.[2] In a letter dated February 1, 1985, counsel for the receiver stated that "[h]aving monitored the CFTC's efforts over the past several months, the Receiver supports the CFTC's motion in all aspects."[3]

*Discussion*

The parties do not dispute that the purpose of disgorgement is neither to compensate victims nor to punish wrongdoers; rather, disgorgement is a remedial measure aimed at depriving the wrongdoer of his "ill-gotten gains." *See SEC v. Blatt*, 583 F.2d 1325, 1335 (5th Cir. 1978); *CFTC v. United States Metals Depository, Inc.*, 468 F. Supp 1149, 1163 (S.D.N.Y. 1979). The heart of the present dispute is the proper measure of such "ill-gotten gains." According to the CFTC, British American's

unregistered status and its fraudulent sales activity are each a sufficient basis for disgorgement and, considered together, provide ample support for an order compelling Forma to disgorge all compensation he received from British American from December 9, 1976 to the end of 1978. Forma, however, contends that he may properly be compelled to disgorge only those proceeds that he received from fraudulent activities from December 9, 1976 until May, 1977. Forma argues that since the findings of the court as to fraud were based on evidence heard in April and May, 1977, such findings do not affect proceeds received after the date of the hearing.[4] Furthermore, according to Forma, no disgorgement of any kind may be ordered on the present record since the CFTC has not proved the extent to which Forma's compensation may be chargeable to fraud.

It is true, as Forma contends, that where a party receives benefits from both legal and illegal activities, the party seeking disgorgement has the burden of isolating the portion of income attributable to illegal activities. *See SEC v. Wills*, 472 F. Supp, 1250, 1276 (D.D.C. 1978); *CFTC v. Hunt*, 591 F.2d 1210, 1221 1223 (7th Cir.), *cert. denied*, 442 U.S. 921 (1979). However, the CFTC did not bear any such burden in the present case, since all of Forma's compensation from British American can be attributed to illegal conduct, including pervasive fraud and unregistered trading. Contrary to Forma's mistaken assumption that fraud is the only ground for disgorgement, courts have often found disgorgement an appropriate remedy for illegal (though nonfraudulent) activities. *See CFTC v. Co Petro Marketing Group, Inc.*, 502 F. Supp. 806 (C.D. Cal. 1980), *aff'd*, 680 F. 2d 573 (9th Cir. 1982) (off-exchange futures transactions); *CFTC v. Hunt, supra* (trading in excess of speculative limits).

Moreover, even if Forma's illegal conduct in this case had been limited to fraud, the fraud here was so thorough and widespread as to taint the entire enterprise and all proceeds flowing therefrom. As the court found, "[t]he violations occurred in a regular, organized manner as part of a professionally structured system of business, and cannot be characterized as random or isolated incidents." *CFTC v. British American, supra* at 22,703.

In view of the nature and extent of fraudulent activities found in this case, disgorgement of all benefits received by Forma would be entirely proper. *See Kelley v. Carr*, 567 F. Supp. 831 (W.D. Mich. 1983).

The only real issue is the proper time period for which benefits should be disgorged.[5] It is clear that all income Forma received from British American in 1977, as disclosed on Forma's W-2 and income tax forms, should be disgorged. The evidentiary hearings held in April and May, 1977, revealed extensive regulatory violations and fraud, and Forma does not allege that between May and September, 1977 (when it ceased doing business) British American ever registered or otherwise conformed to CFTC regulations.

However, the CFTC has not presented an adequate evidentiary basis for the disgorgement of proceeds received by Forma between December 9 and December 31, 1976. In this regard the CFTC has presented proof only of what Forma received in all of December, without isolating the portion of proceeds received in the last three weeks of the month. Seeking to diminish the significance of December 9, 1976, the effective date of the current anti-fraud regulation, the CFTC in its supplemental papers argues that British American's fraudulent activities actually originated in October, 1975, when British American began operations, and that such activities violated regulations then in effect. While this is likely true, it is not the theory that the CFTC advanced in its complaint or in its application for disgorgement. The court is not persuaded that is should now disregard the December 9 date for the limited purpose of permitting the disgorgement of proceeds received in the entire month of December.

The record with regard to 1978 also seems too thin to support a disgorgement order for that year. According to Forma's deposition testimony, the compensation he received in 1978 from British American was derived from "winding down [company] assets," including assets that dated from August, 1975. While Forma's testimony was clearly self-serving, the CFTC has not presented

any evidence refuting his statements on this issue. In the absence of proof regarding the extent to which Forma's 1978 income was derived from post-December 9, 1976 activities, the court declines to order the disgorgement of any income received in that year.

*Conclusion*

For the foregoing reasons, the motion for an order of disgorgement is granted with respect to Forma's income received from British American in 1977, but denied with respect to such income received in 1976 and 1978. It is hereby ordered that John Forma disgorge to the receiver $1,023,375.

So Ordered.

U.S.D.J.

Dated: White Plains, New York
April 17, 1985.

*Footnotes*

1. The original figure ($1,211,840) represents income to Forma received from December 1, 1976, through December 31, 1978; the alternative figure represents income to Forma received from December 1, 1976, through December 31, 1977.

2. The court twice suspended its consideration of this motion at the parties' request.

3. According to the letter, the receiver sought disgorgement only from British American because he believed that "*his* seeking disgorgement from Mr. Forma personally would result in a protracted and expensive investigation and litigation, thereby dissipating the assets of the receivership . . . then available to the claimants" (emphasis in original).

4. Forma does not contest the findings of the court as detailed in its August 31, 1977 decision.

5. The court has considered Forma's numerous objections to any disgorgement and finds them unmeritorious. In particular, in view of the extensive hearings and subsequent opportunity to present evidence of this issue, it is especially curious for Forma to claim that any disgorgement order would violate his due process rights.

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

----------X

COMMODITY FUTURES TRADING COMMISSION,

Plaintiff, 77 Civ. 1822 (LPG)

— against —

BRITISH AMERICAN COMMODITY OPTIONS CORP. and JOHN FORMA,

JUDGMENT

Defendants.

----------X

A motion having been made by the plaintiff herein for an order compelling defendant John Forma to disgorge either $1,211,840 or $1,035,845, the amount of compensation he received from British American Commodity Options Corp. since December, 1976, in an action in the United States District Court in the Southern District of New York, and the Court having heard the argument of counsel and being fully advised, it is

ORDERED AND ADJUDGED that the plaintiff's motion is granted with respect to the income John Forma received from British American Commodity Options corp. in 1977, and it is

ORDERED AND ADJUDGED that the plaintiff's motion is denied with respect to the income John Forma received from British American Commodity Options Corp. in 1976 and 1978, and it is further

ORDERED AND ADJUDGED that John Forma disgorge to Thomas F. Egan, the Receiver of British American Commodity Options Corp., the sum of $1,023, 375.

Dated: White Plains, New York
May 8, 1985

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U.S.D.J.

## APPENDIX B

No. 1022 August Term 1985
(Argued March 24, 1986) Decided April 15, 1986
Docket No. 85-6152

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COMMODITY FUTURES TRADING COMMISSION,

*Plaintiff-Appellee,*

— against —

BRITISH AMERICAN COMMODITY OPTIONS CORPORATION and JOHN FORMA,

*Defendants,*

JOHN FORMA,

*Defendant-Appellant.*

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BEFORE:

MANSFIELD, TIMBERS and MESKILL, *Circuit Judges.*

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Appeal from an order entered April 17, 1985 in the Southern District of New York, Lee P. Gagliardi, *District Judge*, requiring appellant Forma to disgorge to the court-appointed receiver the sum of $1,023,375, appellant's entire 1977 income derived from British American Commodity Options Corporation, based on fraudulent conduct in the sale of commodity options and failure to register as a futures commission merchant.

Affirmed.

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Paul Chernis, New York, N.Y. (Lowy & Chernis, New York, N.Y., on the brief), *for appellant John Forma.*

Edward S. Geldermann, Attorney, Commodity Futures Trading Commission, Washington, D.C. (Pat G. Nicolette, Deputy General Counsel and Whitney Adams, Deputy General Counsel, Washington, D.C., on the brief), *for appellee.*

PER CURIAM:

Appellant John Forma, the sole shareholder of British American Commodity Options Corp. ("BACO"), appeals from an order entered April 17, 1985 in the Southern District of New York, Lee P. Gagliardi, *District Judge*, requiring appellant to disgorge the income which he received from BACO in 1977. Appellant claims that the court erred in requiring disgorgement because the Commission failed to establish a nexus between the proceeds from Baco and the wrongful conduct, and because BACO's failure to register as a futures commission merchant is not a proper basis for disgorgement of proceeds.

Since October 1975 when BACO commenced operations as an options broker, the Commodity Futures Trade Commission ("Commission") has attempted to bring BACO's activities within the requirements of the Commodities Exchange Act and the regulations promulgated thereunder.[1] The instant action stems from the Commission's complaint against BACO which alleged that since January 17, 1977, BACO, with the aid of appellant Forma, had engaged in the options trading business without registering as a futures commission merchant ("FCM") in violation of the Commission's regulations, 17 C.F.R. § 32.3(a) and (b)(1) (1985), and that from December 9, 1976 appellant and BACO had conducted a fraudulent options scheme. The district court conducted extensive hearings in April and May of 1977. In an opinion dated August 31, 1978, *CFTC v. BACO and John Forma* [1977-80] Comm. Fut. L. Rep. (CCH) ¶ 20,662 (S.D.N.Y. 1978), the district court found abundant evidence that BACO and appellant had violated flagrantly both the registration requirements and the anti-fraud provisions of the Commodities Exchange Act. BACO and appellant, according to the court, seriously misrepresented the risks, guarantees, costs, mechanics of commodities investments, as well as BACO's status and expertise.The court issued an injunction against BACO. A receiver, authorized to make application for disgorgement, was appointed. Following a series of depositions and hearings on the issue of disgorgement of proceeds from appellant individually, the district court ordered disgorgement of $1,023,375, the income from BACO which appellant declared on his 1977 income tax return.

Essentially, appellant argues on appeal that the Commission must establish, dollar for dollar, the proceeds that were derived from fraudulent conduct. Appellant also argues that failure to register as an FCM is not an appropriate ground for disgorgement. We disagree.

Generally, where benefits result from both lawful and unlawful conduct, the party seeking disgorgement must distinguish between the legally and illegally-derived profits. *See, e.g., SEC v. Texas Gulf Sulphur Co.*, 446 F.2d 1301, 1308 (2 Cir.), *cert. denied*, 404 U.S. 1005 (1971). *SEC v. Willis*, 472 F. Supp. 1250, 1276 (D.D.C. 1978). The instant case differs, however, since appellant was involved not in isolated instances of fraud, but in systematic and pervasive fraud. In addition, appellant's conduct — his failure to register as an FCM — also was a violation of the Commission's regulations.[2] The problem in this case is finding *any* activity that was lawful. Accordingly, all of the profits earned from BACO's 1977 activities were illegally-derived.

Precedent in other circuits, and precedent in this Court in the securities law context, support disgorgement in this case involving both fraud and regulatory violations. In *CFTC v. Co Marketing Group, Inc.*, 502 F. Supp. 806, 819 (C.D. Cal. 1980), *aff'd*, 680 F.2d 573 (9 Cir. 1982), the court ordered disgorgement where the corporation had violated the prohibition against sales of gasoline futures except through authorized boards of trade. In *CFTC v. Hunt*, 591 F.2d 1211, 1222-23 (7 Cir.), *cert. denied*, 442 U.S. 921 (1979), the court held disgorgement appropriate where the statutory and regulatory limitations on soybean futures contracts were exceeded. Violations of the Commodities Exchange Act and the Commission's regulations in these cases did not necessarily involve fraudulent conduct. We have recognized that disgorgement serves the purpose of depriving the wrongdoer of his ill-gotten gains and deterring violations of law. *SEC v. Texas Gulf Sulphur Co., supra*, 446 F.2d at 1307-09 (SEC's power not limited to injunctive relief; disgorgement was remedial in nature); *SEC v. Manor Nursing Centers, Inc.*, 458 F.2d 1082, 1103 (2 Cir. 1972) (where equity jurisdiction was properly invoked, court had the necessary power to fashion an appropriate remedy; disgorgement of proceeds allowed).

Disgorgement not only deprives the wrongdoer of benefits derived from unlawful conduct but it also effectuates the purpose underlying the Commodities Exchange Act – protection of the investor. In view of BACO's pervasive fraudulent conduct and its failure to comply with the Commission's regulations, we hold that the district court's disgorgement order was necessary and appropriate. We affirm substantially for the reasons set forth in Judge Gagliardi's opinion of April 17, 1985.

Affirmed.

1. On July 22, 1976 ther Commission sought, but was denied, an injunction to prevent BACO from selling London options without first registering and obtaining approval to act as a commodities trading advisor as required by 7 U.S.C. § 6m (1982). On appeal by the Commission to this Court, we held that, since the Commission had established a prima facie violation and likelihood that such violations would continue, an injunction against BACO must issue. *CFTC v. British American Commodity Options Corp.*, 560 F.2d 135 (2 Cir. 1977). BACO began shutting down operations on September 7, 1977.

2. The Commission initially sought disgorgement of proceeds derived from BACO since December 9, 1976. Because of the Commission's inability to specify the fraudulently-derived funds received in December, however, the court denied this request. Regulation 32.3, 17 C.F.R. § 32.3, which requires registration of FCMs with the Commission, took effect on January 17, 1977. From that date, BACO was operating in violation of the regulation.

   We reject Forma's argument that BACO's unregistered operation as an FCM was somehow immunized by the district court's refusal to enjoin BACO's unregistered operation as a commodities trading advisor ("CTA"). The FCM registration regulations imposed requirements additional to and distict from those imposed by the CTA registration statute. Furthermore, as we noted in our opinion reversing the district court on the CTA matter: "[T]o the extent that British American's business activities have succeeded through the unlawful [operations] while not registered, British American [and Forma have] been acting at [their] own peril." *CFTC v. British American Commodity Options Corp., supra*, 560 F.2d at 143.

Commodity Futures Trading Commission v. Forma

Docket No. 85-6152

April 11, 1987

Commodity Futures Trading Commission v. Forma

Docket No. 85-6152

April 3, 1986

UNITED STATES COURT OF APPEALS
FOR THE
SECOND CIRCUIT

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COMMODITY FUTURES TRADING COMMISSION,

*Plaintiff-Appellee,*

v.

BRITISH AMERICAN COMMODITY OPTIONS CORPORATION and JOHN FORMA,

*Defendants,*

JOHN FORMA,

*Defendant-Appellant.*

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OPINION

PER CURIAM:

APPENDIX C

# United States Court of Appeals
*for the*
# Second Circuit

At a stated Term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse in the City of New York, on the sixth day of May one thousand nine hundred and eighty-six

**Present:**

HON. WALTER R. MANSFIELD,
HON. WILLIAM H. TIMBERS,
HON. THOMAS J. MESKILL,

**Circuit Judges,**

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COMMODITY FUTURES TRADING COMMISSION,

*Plaintiff-Appellee,*

—v—

BRITISH AMERICAN COMMODITY OPTIONS CORPORATION and JOHN FORMA,

Docket No. 85-6152

*Defendants,*

JOHN FORMA,

*Defendant-Appellant.*

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A petition for a rehearing having been filed herein by Appellant - John Forma
Upon consideration thereof, it is
Ordered that said petition be and it hereby is DENIED.

Elaine B. Goldsmith,
Clerk